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June 1987

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Taxes and Ability to Pay

In theory Canada's tax system is based on the ability to pay: The higher your income, the more tax you can and should pay.

In reality, only the personal income tax system is at all progressive. Moreover, the large number of tax exemptions and deductions that have crept into the system over the years have blunted its progressivity because such tax breaks bestow their greatest benefit on upper-income taxfilers.

Personal income taxes levied by Ottawa and the provinces are only part of the overall tax system. Federal and provincial consumption taxes - sales taxes, excise taxes and duties - are regressive, which means their burden decreases as income increases: Low-income consumers pay more of their income in consumption taxes than the middle class, and the middle class more than the affluent. Property taxes, applied at the municipal level of government, also are regressive in impact.

On balance, our tax system as a whole is not progressive. It is regressive for lower-income Canadians and proportional for the rest (i.e., middle- and upper-income families and individuals end up paying about the same percentage of their income to the various forms of tax, but less than the poor). **The overall tax system stands the principle of ability to pay on its head. It hits hardest those who can least afford to pay.**

Recent Budgets Have Made the Tax System More Unfair

Federal budgets in 1983, 1985, 1986 and 1987 have further eroded the progressivity of the tax system by imposing increases in income taxes and federal consumption taxes which hurt the working poor the most and by bestowing tax breaks which most benefit the well-off.

These tax changes are documented in the other factsheets in this series and have been analyzed in two previous reports by the National Council of Welfare - Giving and Taking: the May 1985 Budget and the Poor and The Impact of the 1985 and 1986 Budgets on Disposable Income. Briefly:

a. The elimination of the federal tax reduction, the partial indexation of tax brackets and personal exemptions and the imposition of a surtax have increased income taxes for the working poor and middle-income taxpayers. More and more low-income Canadians are being added to the tax rolls as the taxpaying threshold is pushed further and further below the poverty line.

b. Each budget since 1985 has raised federal sales and excise taxes and duties, putting the heaviest burden on consumers with below-average incomes.

c. The two positive initiatives for lower-income Canadians - an increase in the child tax credit and the introduction of a refundable sales tax credit - have, for the working poor, been more than cancelled out by the combination of hikes in income tax and federal sales and excise taxes.

d. All but the poorest families with children end up with lower child benefits because of the partial indexation of the family allowance and the reduction in the children's tax exemption.

e. Upper-income taxpayers have been granted generous tax breaks in the form of large increases in the tax deduction limits for contributions to private pension plans and RRSPs. Wealthy Canadians stand to gain from the new $500,000 lifetime capital gains exemption.

Reversing the Trend?: the Promises of Tax Reform

The Finance Minister has launched a comprehensive reform of the entire tax system - personal, corporate and sales tax. He plans to get more revenue from corporate and sales taxes and less from income tax. He says the changes introduced in the White Paper on Tax Reform on June 18 will produce a fairer tax system. Supposedly the large majority of Canadians will be better off since sales tax increases will be more than offset by income tax cuts.

The income tax system will be reformed by lowering marginal tax rates and reducing their number from ten to three. The Finance Minister will convert "personal exemptions and deductions to tax credits" to make the tax system "fairer and more progressive". There will be fewer tax breaks for high-income taxpayers, who as a result will pay "their fair share of tax".

Tax reform will broaden the corporate income tax base as well by eliminating or reducing many tax preferences. Corporate tax rates will be lowered. As a result, "many more profitable corporations will pay tax, and government revenues from corporate income tax will increase".

There will be a new federal sales tax that will apply to a broad range of goods and services. The sales tax credit will be strengthened to protect low-income Canadians from the tax increases that will result.

Tests for Tax Reform

Tax reform is a complex and ambitious undertaking. Here are some things to keep in mind when assessing the proposals in the upcoming White Paper on Tax Reform, particularly as they affect low and modest-income Canadians.

1. Who Will Benefit Most From Income Tax Cuts?

Lowering marginal tax rates likely will benefit higher-income taxpayers most and lower-income Canadians least. On the other hand, converting exemptions and some deductions to tax credits will raise taxes for higher-income taxpayers and reduce them somewhat for lower-income taxfilers. Where taxpayers in different income groups end up after tax reform will be a question of the balance between these two sets of changes.

According to the Finance Minister, the large majority of Canadians will pay less income tax after tax reform. What income level will mark the dividing line between 'winners' and 'losers'? Will it be average income, which is an estimated $46,000 for a couple and two children and $18,000 for a single person? Will it be higher than average income?

More important, within the winning majority, which income groups will enjoy the largest income tax cuts? Fairness would suggest that it should be the working poor and modest-income taxpayers (i.e., families in the $15,000-$25,000 income range), since they have been hit hardest by tax changes over the last few years. Low-income Canadians should pay no income tax after tax reform.

2. Which Tax Breaks Will Be Changed, and Into What?

Tax reform will convert personal exemptions (the basic personal exemption, age exemption, married or equivalent exemption, children's exemption and other dependants exemption) and "some" deductions to credits.

In general, upper-income taxfilers benefit disproportionately from deductions whereas the tax savings from exemptions are spread more widely throughout the income range. Taxfilers with incomes above $50,000 represent only 4 percent of all taxfilers claiming deductions yet take home 23 percent of all federal tax savings from deductions, compared to just 7 percent of federal tax savings from exemptions. Conversely, taxfilers with income below $20,000 account for over 60 percent of taxfilers claiming deductions and exemptions but receive only 24 percent of federal tax savings from deductions as compared to 47 percent of tax savings from exemptions. (Tables 1 and 2 at the end of this paper provide more information on this point, and the factsheet entitled Tax Expenditures: Who

Gets What looks at a variety of individual exemptions and deductions).

Will tax reform tackle some of the more regressive tax deductions, such as the deductions for contributions to private pension plans and RRSPs? To date the Finance Minister has moved in the **opposite** direction, boosting tax deduction limits for private pension plans and RRSPs and bestowing a $500,000 lifetime capital gains exemption on the rich. Fair tax reform would transform the private pension plan and RRSP deductions into credits and abolish or at least scale down the capital gains exemption.

In moving to credits, the Finance Minister can choose a variety of types. A diminishing refundable tax credit, like the child tax credit and sales tax credit, will target its benefits on lower-income Canadians - including those below the taxpaying threshold - and will exclude those above a certain income level. A flat-rate refundable tax credit will provide the same benefit to all Canadians regardless of their income, including the poor. A non-refundable tax credit will deliver the same benefit to most taxpayers but will pay less to working poor taxpayers who pay less income tax than the credit and nothing at all to the very poor. A diminishing non-refundable tax credit will exclude higher-income taxpayers. (See the factsheet The Hidden Welfare System: Exemptions, Deductions and Credits).

One rumoured change is replacing the $2,640 age exemption and $1,000 pension income deduction with non-refundable tax credits.

Tax reform may do away with some tax breaks altogether. One often-mentioned candidate is the $1,000 deduction for interest income.

In assessing each exemption and deduction, the White Paper on Tax Reform must tell us: 1. whether it serves a purpose that is worth supporting with public funds; 2. if so, then is there any reason why it should not be converted to a credit rather than kept as an exemption or deduction?

3. Tax Reform Must Restore Indexation

The biggest single tax grab over the past few years has been the switch from full to partial indexation of tax brackets and exemptions. (See Why Your Taxes Have Been Going Up: Partial Indexation). This change amounts to a hidden tax increase because most taxpayers do not notice it when they file their tax returns. It is also a regressive move which hits the working poor hardest and the well-off least.

Tax reform must restore full indexation of the income tax system. Tax brackets and tax credits - including the sales tax credit - should be fully indexed to the cost of living each year. If the Finance Minister keeps the tax system partially indexed, inflation will eat away at the gains from tax reform as income taxes creep steadily upward with the passing years.

4. Will an Expanded Sales Tax Credit Adequately Protect the Poor?

Low-income Canadians spend less in dollar terms on food, clothing, shelter and most other items than those with higher incomes. However, these expenditures take a much larger percentage of their incomes simply because the latter are so small. Families with income of $50,000 or more living in major cities spent on average $19,997 on food, clothing and shelter in 1984 compared to $6,725 for families in the under-$10,000 group. However, food, clothing and shelter accounted for only 32.8 percent of total expenditures for families in the $50,000 and over range in contrast to 56.5 percent for those in the low-income group. Food alone represented 22.1 percent of the low-income families' total spending compared to just 12.2 percent for those in the top income group.

The same thing applies to sales taxes, which are regressive because they take more in relative terms from the poor. The current federal sales and excise tax system takes an estimated 11.5 percent of the income of families earning $10,000, 6.7 percent from those earning $40,000 and only 4.4 percent of the income of families with $100,000 in earnings.

The new federal sales tax will apply to a broad range of goods and services. This has raised concerns abouts its impact on lower-income consumers, particularly if (as is likely) it taxes food.

The Finance Minister knows this and has promised to boost the sales tax credit in order to protect low-income Canadians from the new sales tax. How adequate will the new sales tax credit be and whom will it protect?

The existing sales tax credit pays $50 per adult and $25 per child and is reduced by five cents for every dollar of income above $15,000. A couple with two children, for example, gets a sales tax credit of $150 if its net income is below $15,000 and the credit disappears once its net income exceeds $18,000 - well below the estimated $22,532 low-income line for a family of four living in a metropolitan center.

To **fully** offset the burden of the new federal sales tax on low-income Canadians would require a sales tax credit in the order of $400 per adult and $200 per child. A couple with two children would receive a sales tax credit of $1,200. If such an expanded credit were reduced according to the same formula as the current system - five percent of income above $15,000 - it would pay its maximum benefit to those with net incomes below $15,000 and a partial benefit to families with incomes up to $39,000 (for a couple with two children). Since the average income for a couple with two children is approximately $46,000, a sales tax credit of this design would fully protect most poor Canadians and ease the sales tax burden on the working poor (for families of four, those in the $15,000 to $22,000 range) and the majority of moderate-income families (i.e., those with incomes above the poverty line but below the average.)

Cost is obviously a key consideration when designing a new sales tax credit. To fully protect low-income consumers and also offset part of the sales tax burden on those with moderate incomes will cost a lot more than protecting only the poor. However, if the expanded sales tax credit is restricted to low-income Canadians, then those with incomes above the poverty line but below the average will be hardest hit by the new federal sales tax.

It is essential that the sales tax credit, whatever its value and design, be fully indexed to the cost of living. Otherwise the value of the credit will be eroded by inflation. If the income level for the maximum credit ($15,000 in net family income under the current system, although it may well be raised by tax reform) is not indexed as well, then over time the sales tax credit will serve a declining percentage of Canadians. The sales tax credit also must be increased whenever the government raises the federal sales tax rate.

5. Do Corporations Pay Income Tax?

Ottawa now gets only 11.4 percent of its tax revenue from corporations, half of what it got in 1961 (21.6 percent). The Finance Minister's plan to take more income tax from corporations and less from individuals will appeal to many people.

There are good reasons to reform the corporate income tax. Economists argue that tax preferences in the form of special deductions and write-offs have distorted investments, favored some industries over others, impaired efficiency and reduced the contribution of corporations to government revenues. In addition to curbing such tax breaks, the Finance Minister wants to lower corporate tax rates in order to remain competitive with other nations, in particular the United States which has lowered its corporate tax rates.

However, some tax experts also claim that individual Canadians, not corporations, end up paying corporate income tax. Corporations pass on their income tax - and tax increases - to consumers in the form of higher prices, to employees in the form of lower wage settlements and to shareholders in the form of smaller dividends. To the extent that part of the corporate income tax burden is actually shouldered by consumers and employees, it likely has a regressive impact.

6. A Visible Tax System

Partially indexing the personal income tax system was a shrewd move on the part of the Finance Minister not only because it will add many millions of dollars to the government's coffers, but also because it was an invisible tax change that most taxpayers do not

understand. The federal sales tax is also invisible; it is included in the price of the goods to which it applies. As a result, consumers do not know how much federal sales tax they are paying.

The new federal sales tax should be made visible to consumers by requiring that it be added to bills in the same way that provincial sales taxes are itemized on sales slips.

Tax reform also should ensure that the Department of Finance make the cost of tax exemptions, deductions and credits known to Canadians through the publication of an annual tax expenditure account for both the personal and corporate income tax systems. Besides estimating the cost of each tax expenditure, the annual account should provide a breakdown of its benefits to persons in different income groups. Similar information should be given each year on the impact of sales and excise taxes and duties on consumers at different income levels.

7. The Acid Test: The Real Tax Burden

The Finance Minister has promised that tax reform will lighten the tax burden for most Canadians, even after taking into account the impact of the new federal sales tax.

There are two tests for tax reform on this crucial point. First, will income tax cuts offset the cost of the new federal sales tax, particularly for Canadians who are above the poverty line but have below-average incomes?

We must also gauge the success of tax reform over time. If the new tax system is not fully indexed, income taxes will resume their upward march and the sales tax credit will both decline in value and serve fewer and fewer people. The tax burden will grow even heavier in future if the government chooses to raise the federal sales tax rate without a corresponding increase in the sales tax credit.

8. Tax Reform and the Guaranteed Income

The perennially popular notion of a guaranteed annual income is in vogue once again. As always, the problem is how to get there from here. Tax reform may hold an important part of the answer.

The existing refundable tax credits (the child tax credit and the sales tax credit) and others that might arise from tax reform could move Canada an important step forward on the road to a guaranteed income in the form of a negative income tax - i.e., using the tax system to deliver income supplements to low-income families and individuals, including the growing number of working poor. One option the Finance Minister is considering is a national sales tax which would replace both the federal sales tax and

provincial sales taxes. If the national sales tax were accompanied by a joint federal/provincial refundable sales tax credit delivered quarterly or monthly and coordinated with provincial social assistance programs, tax reform would achieve a significant breakthrough in social policy.

Table 1

Distribution of Total Personal Exemptions, Claimants and Benefits, 1984 Tax Year

Income Group ($000)	Takeup Rate	Average Benefit	Share of Benefits	Share of Claimants	Inequality Index
Under 10	99.8%	$ 455	18.8%	37.4%	0.50
10-20	100.0	937	27.8	26.9	1.03
20-30	100.0	1,146	22.3	17.7	1.26
30-40	100.0	1,440	16.1	10.1	1.58
40-50	100.0	1,625	7.7	4.3	1.79
50 and over	99.9	1,895	7.4	3.6	2.09
Average	99.9	908			

Table 2

Distribution of Total Deductions, Claimants and Benefits, 1984 Tax Year

Income Group ($000)	Takeup Rate	Average Benefit	Share of Benefits	Share of Claimants	Inequality Index
Under 10	76.1%	$ 123	6.0%	31.3%	0.19
10-20	99.6	385	17.7	29.5	0.60
20-30	99.9	729	22.1	19.4	1.14
30-40	100.0	1,140	19.9	11.1	1.78
40-50	99.9	1,591	11.7	4.7	2.49
50 and over	99.9	3,662	22.5	3.9	5.73
Average	90.9	639			

Notes

1. 'Takeup Rate' is percentage of taxfilers in each income group who claim exemptions/deductions.

2. 'Average Benefit' is average federal tax savings per claimant from exemptions/deductions for each income group.

3. 'Share of Benefits' is each income group's percentage of federal tax savings from exemptions/deductions.

4. 'Share of Claimants' is each income group's percentage of taxfilers who claim exemptions/deductions.

5. 'Inequality Index' is share of benefits divided by share of claimants. Figures under 1.0 indicate the income group's claimants get a disproportionately low share of tax savings from the tax expenditure. Figures over 1.0 indicate the income group's claimants get a disproportionately large share of tax savings from the tax expenditure.

Figure A
Federal Income Tax Changes Between 1985 and 1987, Single Person, by Employment Earnings

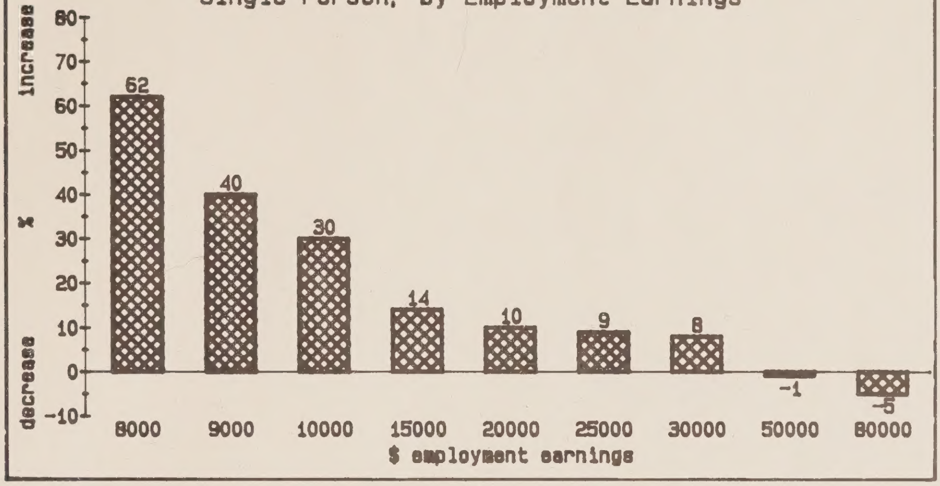

Figure B
Federal Income Tax Threshold and Poverty Line, Two-Earner Couple With Two Children, 1985-1987